CYBERSURF CORP. ANNUAL REPORT 2004

Contents

Cybersurf Corp. ("Cybersurf" or the "Corporation") is an independent Internet communications and technology company providing Canadians with a value-driven alternative to large incumbent carriers. Cybersurf believes many Canadians want ''The Freedom of Choice' that comes with having a truly independent Internet and Long Distance provider as an alternative to Canada's larger incumbent Telco or cable carriers - a choice that allows users to connect to the Internet and make long distance calls how they want and with an independent provider that focuses on the needs of today's average user by providing quality service at the lowest possible price. Cybersurf is that choice.

Cybersurf Corp. operates through three wholly owned subsidiaries, Cybersurf Technologies Corp., 3web Corp., and Comnet Corporation. Cybersurf Technologies Corp. is responsible for the development of Internet-related software products and services, and for all implementation and licensing initiatives pertaining to unique Internet based software technologies. 3web Corp. utilizes Cybersurf Technologies Corp.'s products and services in its national premium dial-up and broadband Internet services 3webXS and 3webXS High Speed to provide the Company with operational cost efficiencies and a competitive advantage over other ISPs. Comnet Corporation provides dial-up and broadband Internet access to the Ottawa area.

For over ten years, Cybersurf has been a company of impressive firsts, developing innovative and leading-edge software applications to fully exploit the Internet's potential as a business tool. This history of innovation began in 1994 with the development of the world's first remote access application service provision system, the Virtual T1. Cybersurf also was the first company in the world to facilitate full transaction online banking through its FirstLink software. In 1998, Cybersurf launched 3web, another industry-leading accomplishment that rapidly became Canada's largest Internet service supported entirely by advertising revenue. Because of the meltdown of the technologies markets and the decline of online advertising revenues, the Company quickly shifted its focus from free to fee-based Internet delivery with the release of 3webXS, a service designed to provide the highest possible quality at the lowest possible price. In 2003, Cybersurf launched its 3webXS High Speed Internet service in Eastern Canada, becoming the first Independent Internet Service Provider to have signed a third-party Internet access agreement with one of the country's largest cable companies. Most recently, Cybersurf expanded its High Speed Internet service in Western Canada, becoming one of the first Independent National Broadband providers.

Cybersurf Corp. is led by its founder, Paul Mercia, who credits the company's success to an entrepreneurial and highly committed team located in offices in Calgary and Ottawa.

About Cybersurf Technologies Corp.

Cybersurf Technologies Corp. develops innovative software solutions for Internet Service, Internet Portal and New Media applications. Through innovation and industry, Cybersurf Technologies Corp. develops and deploys advanced software applications for Internet Service, Internet Portal and New Media ventures. These applications are designed to maximize available resources, reduce operating costs and create new revenue opportunities. The Company's technology solutions are transferable and provide a cost-effective structure to companies that use them, whether their customers use dial-up, ADSL or Cable. Practical applications of these technologies exist through-out the operation of the Company's 3web-branded Internet services.

The software developed by Cybersurf Technologies Corp. creates revenue-generating and cost-cutting opportunities for any Internet company focused on client acquisition, content delivery or advertising revenue - elements vital to any company in the Internet sector. In September 2004, Cybersurf partnered with Alterna-call to provide wholesale Dial-up and Broadband services under a white-labeled program to upsell to their existing customer base. Because these proprietary software solutions offer tremendous potential for widespread application and demand, Cybersurf continues to explore licensing opportunities related to these unique technologies, both in Canada and worldwide. Cybersurf's goal is to leverage these efforts to transform itself from a market leader in Canada into a global player in the Internet technology arena.

About 3web Corp. and Comnet Corporation

3web Corp., a wholly owned subsidiary of Cybersurf Corp. and one of Canada's largest independent Internet service providers, is the first company in the world to

showcase the various proprietary software applications developed by Cybersurf Technologies Corp.

3web Corp. originally launched its free Internet service 3web in August 1998, which it rapidly developed into Canada's largest free Internet service supported entirely by advertising revenue. In 2001, 3web Corp. shifted its focus from free to fee-based service with the launch of 3webXS, a service designed to provide the highest possible quality at the lowest possible price. Most recently, 3web Corp. has expanded its broadband service, to several Western Canadian cities, expanding its National Broadband Network. Subscriber numbers for 3webXS and 3webXS High Speed are grown both organically and through the acquisition of other successful ISPs. 3web Corp. also operates a national long distance service under the brand 3webLD.

3web Corp.'s immediate goals include the pursuit of additional accretive acquisition targets to augment the Company's national subscriber base and financial performance, and the continued broadening and optimization of 3web's dial-up and high-speed networks. Currently, Cybersurf, through its affiliates, provides services in 32 major centers (600 markets) across Canada, including Barrie, Calgary, Chicoutimi, Edmonton, Gatineau (formerly Hull), Guelph, Halifax, Hamilton, Kingston, Kitchener, London, Montréal, Newmarket, Oshawa, Ottawa, Peterborough, Québec City, Saint John, St. Catharines, St. Jérôme, St. John's, Sherbrooke, Sudbury, Thunder Bay, Toronto, Trois Rivières, Vancouver, Victoria, Windsor and Winnipeg. Canadians can download the latest version of the 3webXS installation software by visiting http://www.get3web.com.

Comnet Corporation was purchased by Cybersurf Corp. in May 2003. Operating through its wholly-owned subsidiary Cyberus Online Inc., Comnet Corporation provides similar products as 3web - delivering dial-up and broadband Internet access throughout Ottawa.

The following discussion and analysis of the financial condition and results of operations of Cybersurf Corp. (the "Corporation" or "Cybersurf") should be read in conjunction with the Corporation's audited consolidated financial statements (including notes) for the year ended June 30, 2004 (sometimes referred to as "fiscal year 2004").

The following discussion contains forward-looking statements about matters that involve risks and uncertainties, such as statements of Cybersurf's plans, objectives, expectations, intentions and financial trends. The discussion includes cautionary statements about these matters. The cautionary statements made within this section are applicable to all forward-looking statements wherever they appear in this document. Factors that could cause or contribute to such differences include those discussed in the section entitled "Risks Relating to Cybersurf Corp. and the Internet Industry" as well as those discussed elsewhere herein.

Cybersurf Corp. Year in Review

Cybersurf began fiscal year 2004 with a launch of cable and DSL broadband services in various eastern Canadian markets and ended the year by launching similar cable broadband services in western Canada. Coupled with its strong dial-up subscription base and an increasingly successful long-distance product, the Corporation's annual revenues increased 52% over the previous fiscal year. In fact, Cybersurf would have been profitable but for certain exceptional legal costs associated with claims arising from the proxy battle at the 2002 Annual General Meeting, and the one-time costs associated with the court-approved settlement of the class action lawsuits in British Columbia and Ontario, discussed further below under the headings "Litigation with Mercury Partners & Company Inc." and "Potential Liability in Connection with Termination of Free Internet Service", respectively.

The Corporation's net loss of $597,648 was a reduction of $4,267,388 (88%) over the previous fiscal year. Included in this loss, however, is an accrual for the class action settlement agreement which is discussed in greater detail in the notes to this year's financial statements. While management is satisfied that this settlement avoids greater potential losses in the future, the accrued total expense of $262,920 magnified the loss from $334,728 to $597,648 and accounts for 44% of this total. Additionally, $350,167 in legal expenses were incurred as a result of the Corporation's litigation with Mercury Partners & Company Inc. ("Mercury") and Growth Technologies '98 Limited Partnership ("Growth Technologies"). The General Partner for Growth Technologies is also named as a defendant in the Corporation's claim against Mercury.

The launch of broadband services in new markets also accounts for some of the loss as the revenue generated by these services currently only exceeds the costs to deliver these services by $25,138. During the fourth quarter of fiscal year 2004, the Corporation consolidated two broadband networks to a single wholesale broadband provider removing previous cost inefficiencies. Additionally, the Corporation experienced costs in excess of revenue in new broadband markets until a sufficient number of subscribers were attained.

The Corporation also continued to consume resources in launching broadband services in Western Canada. In fiscal year 2004, the Corporation deferred $123,579, primarily attributed to necessary costs associated with the deployment of Cybersurf's broadband services and costs associated with seeking regulatory enforcement of orders against Shaw Cable Systems G.P. ("Shaw") by the Canadian Radio-Television and Telecommunications Commission (the "CRTC"). Despite the fact that Cybersurf has had TPIA (Third Party Internet Access) agreements with Shaw since November 2002 that entitle it to direct intersection with the Shaw Network in each Shaw-serving area west of Thunder Bay, Ontario, Shaw had been unable to provide this intersection as of March 31, 2004. Cybersurf started to see fulfillment of these agreements with Shaw for direct access in Calgary, Edmonton, and Winnipeg during the fourth quarter of this fiscal year. Consequently, these deferred costs are now being amortized on a straight-line basis over 2 years.

Sources of Revenue

3webXS, the Corporation's dial-up Internet service, accounted for the Corporation's primary source of revenue in fiscal year 2004. Revenue earned by Comnet Corporation ("Comnet"), which the Corporation acquired in May 2003, contributed significantly to the Corporation's total revenue. Similar to Cybersurf, this revenue is primarily attributable to Internet access. During fiscal year 2004, the Corporation continued to build its subscriber base in broadband services, having begun offering cable and DSL Internet access in fiscal year 2004 under the name 3webXS for Broadband. Also launched in fiscal year 2004, a high-speed dial-up service augmented revenue earned through 3webXS. Revenue was also generated through the resale of long distance services (3webLD) and through the sale of other value-

added Internet services (such as web hosting and web search services) to the 3web subscriber base.

Classification of Expenses

The classification and nature of expenses remains relatively unchanged from previous years. The three main classes of expenses are direct operating expenses, general and administrative expenses, and marketing and selling expenses.

The largest item in direct operating expenses was that of Internet communication services provided by wholesale network providers. Other significant costs included within direct operating expenses are: credit card processing fees, wholesale long-distance, high-speed access and modem costs, toll-free and 1-900 phone line services for technical support, and costs relating to CD-ROM replication, packaging and distribution. This expense classification also includes the salary and benefit expenses of technical employees involved in the maintenance and support of 3webXS.

The marketing and selling expenses category includes advertising expenses as well as the salaries and benefits of all sales staff. General and administrative expenses are comprised of numerous variables; the most predominant being costs relating to legal services, facility rentals, professional services, and salaries and benefits of management and administrative staff.

Results of Operations

Revenue

The Corporation earned revenue of $10,652,893 in fiscal year 2004 compared to $7,016,756 in the previous fiscal year. This represents an increase of $3,636,137 (52%). Revenues of $2,519,293 were generated in the first quarter of fiscal year 2004; $2,683,863 in the second quarter; $2,730,020 in the third quarter and $2,719,717 in the fourth quarter. In the previous fiscal year, revenues of $1,654,195 were generated in the first quarter; $1,633,538 in the second quarter; $1,689,620 in the third quarter and $2,039,402 in the fourth quarter.

Subscriptions for dial-up Internet services provided through 3webXS and Comnet generated revenue of $7,861,144 in fiscal year 2004. In the prior fiscal year, dial-up subscriptions generated $6,327,180 in revenue through 3webXS and an additional $133,990 from Comnet. This represents an increase of $1,399,974, representing a 22% increase from the previous fiscal year largely due to the fact that Comnet's revenue was only consolidated for 1 month in the previous fiscal year having been acquired in late May 2003.

3webLD, the Corporation's long distance product, generated revenues of $743,986 in fiscal year 2004. This represents an increase of $590,576 (385%) over the previous fiscal year's revenues of $153,410. This large increase comes from a growing subscriber base attracted by competitive rates and the discounts offered through the bundling of Cybersurf's long distance services with the Corporation's other products. Further, 3webLD was new in the previous fiscal year and had generated 59% of its total revenues in the fourth quarter. In the current fiscal year, long distance revenues increased from $128,615 in the first quarter of fiscal year 2004 to $224,070 in the fourth quarter.

Tech support revenue from 1-900 services along with revenue from TLC - an addition to a 3webXS subscription which bundles free technical support with additional services such as a dial-up accelerator - amounted to $251,561 in fiscal year 2004. In the previous fiscal year, tech support revenue amounted to $103,028. The increase of $148,533 (144%) can be attributed to bundling the dial-up accelerator as a benefit of a TLC subscription, which occurred in August 2003.

Revenue from broadband services earned through 3webXS for Broadband and Comnet amounted to $807,792 in fiscal year 2004. There was no revenue earned from broadband services in the previous fiscal year except through Comnet for one month after acquisition in the amount of $28,849. Primarily all of the revenue generated from broadband services in fiscal year 2004 was generated in eastern Canada. The Corporation launched in the western Canadian markets of Calgary, Edmonton, and Winnipeg during the fourth quarter of fiscal year 2004 but these markets were opened too late to contribute any material revenues.

Additional revenue streams derived from the Corporation's expansive communications network also contributed to total revenue. Additional services generated from 3webXS, such as line capacity resale and web search services affiliations, generated $292,081 in fiscal year 2004 compared to $106,772 in the previous fiscal year, an increase of $185,309 (174%).

Additional subscription revenue attributable to corporate client access and website hosting amounted to $396,316 of which Comnet contributed $310,020. In the previous fiscal year, the Corporation had generated $81,125, with

an additional $26,798 contributed by Comnet upon its acquisition in May 2003.

Expenses

Communication Costs, Salaries, and Benefits

Direct operating expenses (referred to as 'Communication Costs, Salaries, and Benefits' on the statement of loss and deficit) increased by $1,365,773 from $5,852,876 in fiscal year 2003 to $7,218,649 in fiscal year 2004 - a 23% increase compared to a corresponding 52% increase in revenue.

The communication costs involved in delivering dial-up access for 3webXS and Comnet amounted to $3,476,913 compared to $3,546,499 in the previous fiscal year. The Corporation has been able to negotiate competitive telecommunication pricing and has effectively utilized and managed capacity on its communication lines to keep these costs at the same level as they were in the previous fiscal year, despite the addition of Comnet's operations.

3web technical support costs are comprised of the salaries and benefits of staff employed to build and maintain the 3web network as well as the staffing and phone line costs involved in supplying the technical support service. These costs amounted to $1,963,966 in fiscal year 2004 compared to $1,610,834 in the previous fiscal year. This increase of $353,132 is primarily attributable to the $264,652 spent to acquire Comnet, which was not included in the total of the previous fiscal year.

Broadband costs of $782,654, which include the cost of modems sold, were not present in the previous fiscal year with the exception of Comnet for one month after acquisition in the amount of $18,560. As the Corporation launches its broadband services in different markets, the Corporation incurs immediate costs that cannot be offset until its subscriber base grows to an appropriate level in each market. These immediate costs will almost surely be present in future markets that the Corporation aims to enter.

Other direct operating expenses for fiscal year 2004 include long distance re-sale costs and transaction costs. Long-distance re-sale costs amounted to $513,809 in fiscal year 2004 compared to $124,287 in the previous fiscal year. Long-distance costs rose by 313% compared to a corresponding 385% increase in long distance revenue. Transaction costs for 3webXS, primarily from processing credit cards, amounted to $513,809 for fiscal year 2004 compared to $324,388 in the previous fiscal year.

General and Administrative Expenses

General and administrative expenses amounted to $2,994,298 in fiscal year 2004, compared to $4,351,143 in the previous fiscal year, representing a decrease of $1,356,845 (31%) despite the addition of Comnet's operations. The Corporation carried out a cost-cutting plan to reduce general administrative expenses during 2003 and much of the savings are more evident in the current fiscal year than they were in the previous year.

Of the total general and administrative expenses in fiscal year 2004, $1,165,237 can be attributed to salaries for both Calgary and Ottawa operations, compared to $1,678,157 in the previous fiscal year, a decrease of $512,920 (31%).

Legal expenses amounted to $452,638 in fiscal year 2004 compared to $657,132 in the previous fiscal year. Of fiscal year 2004's total, $350,167 in legal expenses were incurred as a result of the Corporation's statement of claim against Mercury and Growth Technologies.

Other major components of general and administrative expenses for fiscal year 2004 include premise rent for Calgary and Toronto operations which amounted to $270,478, compared to $539,981 in the previous fiscal year, due to the closure of the Toronto office and the consolidation of 2 Calgary offices during fiscal year 2003 and early 2004, while Comnet's Ottawa operations contributed an additional $64,775 in rent expense. Professional service expenses amounted to $167,409 (FY2003 - 462,152), and provincial taxes amounted to $131,554 (FY2003 - $135,154).

Marketing and Selling Expenses

Marketing and selling expenses decreased by $246,072 (34%) to an amount of $472,244 in fiscal 2004 compared to $718,316 in 2003. A sales and marketing call centre accounted for the bulk of the expense in fiscal year 2004 - $329,513 (70%). This call centre was not in operation for the first 3 quarters of the previous fiscal year and marketing efforts in the previous year and the majority of those expenditures were through advertising ($471,611 or 66%).

Depreciation and Amortization Expense

Depreciation and amortization expense decreased by $157,879 (24%), from $662,946 in fiscal year 2003 to $505,067 in fiscal year 2004.

Interest on Capital Lease Obligations and Long-Term Debt

The Corporation paid interest of $5,688 on capital lease obligations and long-term debt in fiscal year 2004. In the previous fiscal year, $1,038 was expensed as this obligation did not exist prior to the acquisition of Comnet.

Other Income (Expense)

Interest income amounted to $58,203 in fiscal year 2004 compared to $112,844 in the previous fiscal year.

During fiscal year 2004, Cybersurf was awarded $107,985 as compensation for the legal fees that it incurred pursuant to an unsuccessful legal claim by Mercury, as discussed further below under the heading "Litigation with Mercury Partners & Company Inc." This amount is listed under 'Legal Recovery' in the consolidated financial statements.

As discussed further below under the heading "Potential Liability in Connection with Termination of Free Internet Service", the Corporation paid a settlement amount of $222,689 in relation to certain class action lawsuits. This settlement was approved by the courts and implemented in April 2004 in Ontario and B.C., thereby settling two of the three outstanding class action lawsuits. This amount is listed as 'Legal Settlement Expense' in the Other Income (Expense) section of the consolidated statements of loss and deficit.

Net Loss

The Corporation's net loss of $597,648 was a decrease of $4,267,388 (88%), from a loss of $4,865,036 in fiscal year 2003 to a loss of $597,648 in fiscal year 2004. Included in this loss, however, is an accrual for the class action settlement agreement which is discussed in greater detail in the notes to this year's financial statements. While management is satisfied that this settlement avoids greater potential losses in the future, the total expense of $262,920 magnified the loss from $334,728 to $597,648 and accounts for 44% of this total. Additionally, $350,167 in legal expenses were incurred as a result of the Corporation's statements of claims against Mercury and Growth Technologies. The General Partner for Growth Technologies is also named as a defendant in the Corporation's claim against Mercury.

The Corporation's net loss was $19,800 in the first quarter of fiscal year 2004; $48,887 in the second quarter; $300,692 in the third quarter; and $228,269 in the fourth quarter. In the previous fiscal year, the Corporation's net loss was $1,241,634 in the first quarter; $1,496,198 in the second quarter, $1,106,982 in the third quarter and $1,020,222 in the fourth quarter.

The Corporation's basic loss per share was $0.02 in fiscal year 2004, compared to $0.15 in fiscal year 2003. In fiscal year 2004, the basic loss per share was $0.00 in the first and second quarter; $0.01 in the third quarter, and $0.01 in the fourth quarter. In the previous fiscal year, the basic loss per share was $0.04 in the first quarter; $0.05 in the second quarter; $0.03 in the third quarter; and $0.03 in the fourth quarter. Diluted loss per share is not disclosed as the effect of earnings per share is anti-dilutive.

Financial Condition

Cash and Cash Equivalents

As at June 30, 2004, cash and cash equivalents were $1,849,221, equating to 67% of current assets and 29% of total assets. The Corporation has been able to meet its obligations using operating cash flows since its acquisition of Comnet in May 2003 and did not have to use its short-term deposits throughout the three quarters of fiscal year 2004. In the fourth quarter of fiscal year 2004, the Corporation drew on some of its cash to pay the class-action settlement listed in 'Other Income' on the consolidated statement of loss and deficit. Additionally, the Corporation purchased $525,000 in telecommunications hardware and increased its inventory levels with broadband modems to be sold to consumers to help facilitate the sales of its new High Speed service. Consequently, cash and cash equivalents were reduced during the fiscal year by $935,095 (34%).

Accounts Receivable

Current accounts receivable totalled $430,808 at June 30, 2004. This receivable balance can be broken down into trade receivables of $243,554 and other receivables of $187,254. The 'Other Receivables' balance includes an amount related to the Goods & Services Tax owing from Growth Technologies, the former holder of the 3web Edmonton license, and its General Partner Softech Internet Management Corp. ("Softech"). The Corporation has been awarded a summary judgement in the amount of $316,926.90 plus legal costs, and has to date realized and had collected just over $200,000 on this judgement with the anticipation that it will shortly realize the balance of the judgement. Also included in the 'Other Receivables' balance are loans to current and former employees of the Corporation.

Inventory Balance

Inventory increased significantly from $16,328 in fiscal year 2003 to $142,813 in fiscal year 2004 due to the addition of high-speed modems to inventory. In the previous fiscal year, inventory was solely comprised of 3web installation kits.

Prepaid Expenses and Deposits

Prepaid expenses totaled $352,865 as at June 30, 2004 compared to $471,219 at the end of the previous fiscal year. The prepaid balance is comprised of a $200,000 deposit to a wholesale communication provider, along with various software licenses, service contracts, advertising services, and additional security deposits.

Other Receivables

The other receivables balance of $49,470 as at June 30, 2004 represents the portion of current and former employee loans due between July 1, 2005 and December 31, 2007.

Capital Assets

The net balance of capital assets was $1,766,256 as at June 30, 2004 compared to $1,451,258 in the previous fiscal year. The Corporation continues to prudently evaluate any and all significant capital purchases and capital asset purchases were minimal for much of the current fiscal year. However, the Corporation purchased $525,000 in telecommunications hardware late in the fourth quarter which accounts for much of the increase to capital assets.

Patents and Trademarks

Patents and trademarks amounted to $75,045 on the balance sheet as at June 30, 2004. These assets are being amortized on a straight-line basis over five years starting January 1, 2004.

Deferred Development Costs

Deferred development costs totaled $118,430 as at June 30, 2004 and relate to the development of Broadband services in Western Canada. The Corporation successfully began launching these services in western Canadian markets during the fourth quarter of fiscal year 2004 and these costs are being deferred on a straight-line basis over 2 years starting June 2004.

Goodwill

A goodwill balance of $1,666,679 at June 30, 2004 relates to the acquisition of all of the outstanding shares of Internet service provider Comnet and its subsidiary Cyberus Online Inc., for cash consideration of $1,267,050. The transaction was accounted for under the purchase method with the results of the operations being included in the consolidated financial statements from May 29, 2003 onwards.

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities totaled $695,220 as at June 30, 2004 compared to $823,133 in the previous fiscal year. This figure is comprised of general items such as monthly communication expenses, employee vacation liability and trade payables.

Deferred Revenue

Deferred revenue amounted to $412,736 as at June 30, 2004 compared to $550,093 in the previous fiscal year. Deferred revenue is primarily composed of 1-year prepayments of Internet service. Customers on the Corporation's newly launched broadband networks pay only on a monthly basis and consequently do not contribute to the deferred revenue balance.

Obligations under Capital Lease

The Corporation assumed obligations under capital lease through its purchase of Comnet. The current portion of this lease obligation as at June 30, 2004 is $9,726.

Share Capital

Share capital including contributed surplus increased from $39,903,636 as at June 30, 2003 to $40,123,324 as of June 30, 2004. This increase of $219,688 resulted from the exercise of 226,829 options amounting to $35,938 and a private placement of 700,000 shares amounting to $183,750. Total issued and outstanding capital stock for the Corporation is 33,091,684 as at June 30, 2004 compared to 33,123,324 as at June 30, 2003.

Liquidity and Capital Resources

The Corporation continued to make every effort to minimize cash usage during fiscal year 2004. The Corporation used $935,095 in cash and cash equivalents during fiscal year 2004. In the previous fiscal year, the Corporation used $3,901,507.

Operating Activities

After adjusting the net loss for depreciation and changes in working capital, the Corporation had a decrease in cash and cash equivalents of $160,468 in fiscal year 2004 com-

pared to a decrease of cash and cash equivalents of $1,949,389 in the previous fiscal year. The decrease in non-cash working capital from accounts payable and accrued liabilities of $127,913 corresponds to a lower level of trade payables at the end of fiscal year 2004, as compared to fiscal year 2003. The Corporation also used $126,485 in cash to purchase various types of high-speed modems for the different markets that it fulfills throughout Canada. The increase in non-cash working capital from accounts receivable of $214,075 includes the collection of $200,000 which represents a portion of the summary judgement in the amount of $285,254 plus interests and costs awarded to Cybersurf on its claim against Growth Technologies and its General Partner.

Financing Activities

Cash flow from financing activities was $157,688 for fiscal year 2004. During the year, the Corporation used $72,235 to re-pay long-term debt acquired with the acquisition of Comnet. An additional $19,455 was made in capital lease payments. The Corporation's cash position was increased by $29,690 through the repayment of loans receivable and by $219,688 from the exercise of 226,829 options amounting to $35,938 and a private placement of 700,000 shares amounting to $183,750.

Investing Activities

Cash used in fiscal year 2004 for investing activities amounted to $932,315. Telecommunications hardware of $525,000 makes up the majority of the $806,571 used to purchase capital assets in fiscal year 2004. An additional $123,579 was invested into the development of broadband services in Western Canada.

Risks Relating to Cybersurf and the Internet Industry

The Corporation has not had any significant changes to its risks and uncertainties from those that were disclosed in the Management Discussion and Analysis of Financial Condition and Results of Operations for the fiscal year ended June 30, 2002.

The risks and uncertainties described below are not the only risk factors affecting the Corporation. Additional risks and uncertainties not presently known to Cybersurf or that are currently deemed immaterial also may impair the Corporation's business operations. If any of the following risks actually occur, the business, results of operations and financial condition of the Corporation could be materially and adversely affected.

Limited Operating History

The Corporation has recently implemented significant changes to the business model of its Internet access business and this business model should be regarded as unproven. The Corporation may make additional changes to its business model in the future. These factors make it difficult to evaluate or predict the Corporation's performance.

Although a number of other businesses provide services similar to those provided by the Corporation, there can be no assurance that the Corporation's Internet access business will achieve the same results.

The Corporation's software development business to date has not been able to commercialize any of its products or services to a significant degree. There can be no assurance that any such products or services will be successfully commercialized in the future.

Reliance on Telecommunications Carriers

The Corporation's Internet access business substantially depends on the capacity, affordability, reliability and security of its telecommunication networks. The Corporation relies upon Sprint Canada and Bell Canada as its primary providers of network services, although in certain circumstances other providers can be used. Both Sprint Canada and Bell Canada provide similar services to businesses that compete with the Corporation, including businesses operated by or affiliated with Sprint Canada and Bell Canada. Only a small number of providers offer the network services that the Corporation requires. There has been significant consolidation in the telecommunications industry, and there is a significant risk that further consolidation could make the Corporation reliant on an even smaller number of providers. If the Corporation's third-party telecommunication service providers deliver unacceptable service, the quality of Cybersurf's Internet access service would suffer. In this event, the Corporation likely would lose subscribers who are dissatisfied with its service.

Since it does not have direct control over the quality and reliability of its telecommunications carriers' networks, there is no assurance that the Corporation will be able to provide consistently reliable Internet access for its subscribers.

The Corporation's margins are highly sensitive to variations in prices for the telecommunication services it purchases. The Corporation's Internet access business could be harmed if the prices charged to it for telecommunica-

tion services are increased. In addition, the availability and pricing of telecommunications services varies geographically, and the Corporation may not be able to obtain new or substitute telecommunication services in certain geographic areas on commercially reasonable terms, if at all. There is no assurance that the Corporation's telecommunications service providers will continue to provide their services on commercially acceptable price terms, or that alternative services will be available on similar terms.

Operating Losses

As at June 30, 2003, the Corporation had an accumulated deficit of $34,216,936. The Corporation's ability to achieve profitability in the future will depend upon its ability to increase revenues or reduce expenses. Although the Corporation has experienced a dramatic turnaround in its financial performance over the course of the last year, the Corporation cannot be certain that it will be able to increase revenues or that it will obtain sufficient revenues to achieve profitability. If it does achieve profitability, the Corporation cannot be certain that it can sustain or increase profitability on a quarterly or annual basis thereafter.

Competition to Provide Internet Access Services

The Corporation currently competes or expects to compete for users with the following types of companies that provide Internet access services:

- Established online service and content providers;
- Independent national Internet service providers;
- National long-distance carriers;
- Local telephone companies;
- Numerous regional and local Internet service providers;
- Computer hardware and software and other technology companies;
- Cable operators and online cable services; and
- Satellite communication services.

Increased competition could result in additional sales and marketing expenses and user-acquisition costs and also could result in increased subscriber turnover and pressure to reduce the fee charged for the Corporation's service. There can be no assurance that the Corporation will be able to offset the effects of these increased costs, and the Corporation may not have the resources to continue to compete successfully. The ability of its competitors to acquire other Internet service providers or to enter into strategic alliances or joint ventures could also put the Corporation at a significant competitive disadvantage. Existing competitors may take steps such as reducing their user fees, offering promotions for access services or bundling free access services with other product offerings.

In addition, telecommunication companies with far greater resources, distribution channels and brand awareness offer their own Internet access services to users. These advantages reduce the overall cost of Internet access for such companies and may significantly increase competitive pressures on the Corporation.

The telecommunication, cable and other companies that own broadband networks may prevent the Corporation from offering broadband Internet access through the wire and cable networks that they own. The Corporation's ability to compete with telephone and cable television companies that are able to support broadband transmission may depend on future regulation to guarantee open access to their broadband networks.

Management of Cybersurf believes that certain Canadian telecommunication companies are engaging in activities that inhibit competition and the Corporation has participated in the filing of a complaint with the CRTC alleging, among other things, anti-competitive practices and predatory pricing. There can be no assurance that the CRTC will issue a ruling that is favorable to the Corporation and, absent such a ruling, the Corporation may not be able to provide broadband services at a competitive price at any time in the foreseeable future. The inability of the Corporation to enter the broadband market may limit its ability to attract subscribers.

Software and Hardware Defects

The software and hardware used to operate and provide the Corporation's services is complex and, accordingly, may contain undetected errors or failures. Such occurrences have resulted in, and may in the future result in, a number of adverse consequences, including:

- Users being disconnected from 3web Corp.'s service or being unable to access its service;
- Loss of data or revenue;
- Injury to reputation; and
- Diversion of development resources.

Ability to Protect Proprietary Rights

If the Corporation is not able to protect its proprietary rights, it may not be able to compete effectively. The

Corporation principally relies upon copyright, trade secret, and contract law to protect its proprietary technology. The Corporation cannot be certain that it has taken adequate steps to prevent misappropriation of its technology or that competitors independently will not develop technologies that are substantially equivalent or superior to the Corporation's technology.

Potential Liability in Connection with Termination of Free Internet Service

The Corporation was a defendant to three class action lawsuits or potential class action lawsuits in Ontario, B.C., and Quebec which allege that Cybersurf misled consumers relative to certain advertisements offering "Free Internet for Life". Canada Post Corporation is also named as a defendant in these lawsuits and a settlement agreement involving a consumer refund offer has been entered into and implemented with Ontario and B.C. counsel resolving two of the three actions. The Ontario courts approved the certification of a national class excluding British Columbia but including Quebec. Based on the Ontario ruling, the defendants in the Quebec class action will be arguing this precludes the continuation of the Quebec lawsuit. The final outcome of the Quebec lawsuit is indeterminable at this time. Further, there can be no assurance that a government, quasi-government or self-regulating body will not initiate an action against 3web Corp. and/or the Corporation under one or more consumer protection regulations or codes of conduct. In the event that any such claim or action or further claim or action were initiated and were successful, the Corporation could potentially be required to pay damages and/or reinstitute its free service, either or both of which could have a material adverse effect on the Corporation's business, results of operations and financial condition. In addition, the Corporation could incur substantial costs and diversion of management resources in the defense of any claims, regardless of their merit.

Litigation with Mercury Partners & Company Inc.

As a dissident shareholder, Mercury unsuccessfully attempted to replace the current Board of Directors at the Corporation's annual general meeting of shareholders held in 2002 (the "**2002 AGM**"). After the 2002 AGM, Mercury sued the Corporation alleging misconduct by the chairman of the 2002 AGM. The claim was dismissed and Cybersurf was awarded its legal costs. Mercury appealed this decision but the appeal was never prosecuted and was eventually struck.

The Corporation has filed a statement of claim in Alberta against Mercury, its two principal shareholders, and others alleging misconduct and other improper actions in relation to the attempt by Mercury to replace the Cybersurf Board of Directors at the 2002 AGM. The claim seeks damages in excess of $6,000,000 and other relief. While the outcome of the lawsuit is indeterminable at this time, the Corporation could incur substantial costs and diversion of management resources in regards to these claims.

Reliance on Third-Party Suppliers

The operation of the Corporation's fee-based Internet access service requires the accurate operation of billing system software by the Corporation, the provision of services by third-party vendors and the development of policies designed to reduce the incidence of credit card fraud and other forms of uncollectible "chargebacks". The Corporation has a limited history of operating these systems and relationship with these vendors. If the Corporation encounters significant difficulties with these vendors or the operation of these systems, or if errors, defects or malfunctions occur in the operation of these systems, such events could result in erroneous overcharges to customers or in the under-collection of revenue, either of which would hurt the Corporation's business and financial results.

Dependence on Key Employees

The Corporation's business is largely dependent on the personal efforts and abilities of its senior management and other key personnel. Paul Mercia, President and Chief Executive Officer is the founder of the Corporation and is instrumental in the strategic vision and planning of the Corporation. All of the executive officers are important members of the senior management team and bring forth valuable skills and abilities. Any of Cybersurf's officers or employees can terminate his or her employment relationship at any time. The loss of these key employees or the Corporation's inability to attract or retain other qualified employees could seriously harm the Corporation's business and prospects.

Risks Associated with Growth

Given the rapid growth and overall development that the Corporation has experienced over the past several years, it is essential that its internal controls, operating systems and management acumen continue to keep pace with the demands of the marketplace.

Risk of Natural Disaster

The Corporation's equipment and the telecommunication infrastructure of its third-party network providers are vulnerable to damage from fire, earthquakes, power loss, telecommunications failures and similar events. The Corporation has experienced situations where power loss and telecommunications failures have adversely impacted service, although to date, such failures have not been material to its operations. All critical equipment dedicated to our Internet access service is located at our headquarters in Calgary, Alberta. A natural disaster or other unanticipated problem at our headquarters or within a third-party network provider's network could cause interruptions in the services that the Corporation provides. The Corporation's systems are not redundant. Any prolonged disruption of the Corporation's Internet access service due to system failure could result in subscriber account terminations and decreased revenues.

Outlook

The following discussion is based on current expectations of management of the Corporation and the actual results may differ from those discussed below.

Fiscal year 2004 reflected several key successes for the Corporation, including increased revenue, the launch of its broadband Internet service in Eastern Canada and the drastic reduction in administrative and operating expenses. The net result was positive cash flow from operations from June of the fourth quarter of fiscal year 2004 until today. While this milestone validates the Corporation's path-to-profitability strategy, management believes that it could have been achieved a year earlier and by a greater overall margin had it not been for the Corporation's obligation to devote resources to the proxy battle and litigation with Mercury, discussed above under the heading "Litigation with Mercury Partners & Company Inc."

Management believes that the Corporation's businesses have certain strategic competitive advantages that, under the current business model, will make fiscal year 2005 a defining year for the Corporation. These competitive advantages include a strong and incrementally growing base of dial-up, high-speed, long distance and value-added services subscribers; a national network; experience in the rapid growth and maintenance of an Internet access service; and, as a result of operating such service, a platform to showcase the software technologies developed by the Corporation for the global market.

These advantages, combined with the Corporation's commitment to the continuous execution of its existing business plan, the pursuit of accretive acquisition opportunities and the further strengthening of its bottom line, leave management confident that the Corporation has the potential to succeed as an industry leader in the Canadian marketplace.

Paul Mercia

President, C.E.O., Director

Having founded Cybersurf in 1994, Mr. Mercia is the leading force behind the development and execution of the company's long-term business strategy. Mr. Mercia maintains an active role in the continuing development of Cybersurf's innovative technologies. Prior to becoming C.E.O. in July of 1999, Mr. Mercia served as Cybersurf's President and Chief Technical Officer.

Mr. Mercia has been the intellectual architect behind all proprietary software applications since the company's inception. He led the initiative to design, develop and successfully launch 3webXS, Cybersurf's premium, unlimited fee-based Internet service. Most recently, Mr. Mercia has been the driving force behind the development of new 3web services such as long distance, extended customer service, Web mail and high speed Internet access.

Mr. Mercia has many years' experience with and intimate knowledge of Internet related technologies, new media marketing and Internet-based consumer applications, and has developed proprietary communications software and database management applications. Mr. Mercia also has been responsible for the completion of all major financings to date.

Jason Finney, Dip., I.M.C.

Vice President Product Development

Mr. Finney oversees the company's revenue generating software projects and is responsible for their functional integrity and their timely completion.

Working closely with the Software Developers within the Product Development division, Mr. Finney ensures that all functional criteria and timelines are met. The most recent projects to be launched under Mr. Finney's supervision have been 3webXS for High Speed; and the latest release of Cybersurf's Internet connectivity software which can be completely customized, branded and distributed to any ISP.

Mr. Finney comes to Cybersurf with a diverse and extensive new media design skill set, primarily in the fields of computer gaming technology and software development. A graduate of Interactive Multimedia Technology, Mr. Finney is fluent in various new media disciplines, including 3D modeling, computer animation, website development and multimedia authoring.

Russell Holmes

Controller, B.Comm., CGA

Mr. Holmes is responsible for managing the accounting, financial reporting and administrative aspects of Cybersurf. Since joining Cybersurf in 1998, Mr. Holmes has been instrumental in the implementation of the Company's accounting and reporting systems.

Mr. Holmes has been responsible for the execution of many of the cost-cutting and revenue-enhancing activities of the Company during the past year. In addition to his responsibilities in accounting and finance, Mr. Holmes has assumed an active leadership role within the Company.

Mr. Holmes holds a Certified General Accounting designation and a Bachelor of Commerce degree with a concentration in accounting from the University of Calgary.

Patrick M. Lalonde

Vice President Business Alliances

Mr. Lalonde is responsible for identifying, implementing and maintaining Cybersurf's strategic initiatives and alliances. Prior to joining the Company, Mr. Lalonde was co-founder and principal for Comnet Corporation, one of Eastern Canada's largest and most successful ISPs. During his 10 years with Comnet, Mr. Lalonde's credits include the successful acquisition of Cyberus Online Inc., and the deployment of broadband Internet services throughout Ontario and Quebec.

Mr. Lalonde has considerable experience within the Internet Technologies field, excelling in the design, implementation and deployment of Internet and web-based services and applications. Over the course of his career, Mr. Lalonde has pioneered initiatives and technologies independent of previous models or standards.

Charles Rifici B.A.Sc

Vice President Corporate Development

Having joined the Cybersurf team in May of 2003, Mr. Rifici is responsible for the maintenance of Cybersurf's long-term business strategies, and the pursuit of new strategic initiatives and acquisitions. Prior to joining the Company, Mr. Rifici was a principal of Comnet Corporation, a successful Ottawa ISP he co-founded in 1995. Mr. Rifici led Comnet's acquisition of Cyberus Online Inc. in 2001 and was a key player in the Company's business development, finance and operations activities. Mr. Rifici was instrumental in the devel-

opment and implementation of all accounting, reporting and customer relationship management systems throughout his leadership role at Comnet.

Mr. Rifici received his Bachelor in Applied Science in Computer Engineering at the University of Ottawa

Roy Graydon

Director

As Executive Vice-President and Chief Financial Officer of Call-Net Enterprises, Mr. Graydon brings to Cybersurf extensive experience in the business and financial sectors. Prior to joining Call-Net, Mr. Graydon held various senior positions in the investment industry including as a managing partner with VGC Capital Partners, Vice-President with the Ontario Teachers' Pension Plan Board and Vice-President and Director, Investment Banking, with TD Securities Inc.

In addition to serving on the Board of Directors of Cybersurf Corp., Mr. Graydon has served on various boards of directors including those of Call-Net, International Comfort Products Corp., and McDonald, Dettwiler and Associates Ltd. Mr. Graydon is also Vice-Chair of the Board of Trustees of the Ontario Science Centre.

James Milliken

Director

Mr. Milliken has been active in the Canadian securities industry for over 40 years. He is a director of several public companies, and is a former president of the Alberta Stock Exchange and Sanyo Securities Canada Limited.

For the past several years, Mr. Milliken was an associate of the Lomax Group Inc., an Alberta based consulting and advisory organization specializing in mergers and acquisitions.

Jay Roberge

Director

Mr. Roberge is the President of Tehama Ventures Inc., a boutique investment banking firm providing strategic business consulting, M&A advisory, and private placement services to emerging market companies. Mr. Roberge has fifteen years extensive business management and public company experience and is recognized for his contribution to a number start-up and early stage technology companies in Internet services, new media and software.

As Chief Executive Officer of Knowledge Networks Inc, Mr. Roberge successfully raised seed and early stage capital and secured strategic partnerships with fortune 500 corporations as part of providing the strategic vision and direction for the Company.

In Canada, Mr. Roberge is recognized in the Canadian Internet Industry for his role as Vice President Sales and Marketing of Canada Internet Direct (now Look Communications Inc), and his contribution in taking this company from a start-up to one of Canada's largest and most successful Internet Service Providers with annualized revenues of approximately $15M.

Mr. Roberge sits on the advisory board and board of directors for a number of both private and publicly traded high tech companies in both the US and Canada, including Noise Media Inc., Alta Terra Ventures and Printlux Inc. among others.

AUDITORS' REPORT TO THE SHAREHOLDERS OF CYBERSURF CORP.

We have audited the consolidated balance sheets of Cybersurf Corp. as at June 30, 2004 and 2003 and the consolidated statements of loss and deficit and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at June 30, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Deloitte & Touche LLP

Calgary, Alberta
September 10, 2004

CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT
YEARS ENDED JUNE 30, 2004 and 2003

	2004	2003
	$	$
REVENUE	**10,652,893**	7,016,756
EXPENSES		
Communication costs, salaries and benefits	**7,218,649**	5,852,876
Depreciation and amortization	**505,067**	662,946
General and administrative, marketing and selling	**3,466,542**	5,069,459
Interest on obligations under capital leases	**5,327**	472
Interest on long-term debt	**361**	566
	11,195,946	11,586,319
LOSS BEFORE THE FOLLOWING	**(543,053)**	(4,569,563)
OTHER INCOME (EXPENSE)		
Interest income	**58,203**	112,844
Legal recovery (Note 17d)	**107,985**	-
Legal settlement expense (Note 17c)	**(222,689)**	-
Loss on sale of capital assets	-	(429,122)
Loss on sale of foreign subsidiaries	**(1,428)**	-
	(57,929)	(316,278)
LOSS BEFORE NON-CONTROLLING INTEREST	**(600,982)**	(4,885,841)
NON-CONTROLLING INTEREST IN SUBSIDIARIES' ACTIVITIES	-	27,938
LOSS BEFORE INCOME TAXES	**(600,982)**	(4,857,903)
(RECOVERY OF) PROVISION FOR INCOME TAXES (Note 14)		
Large Corporation Tax	**(3,334)**	7,133
NET LOSS	**(597,648)**	(4,865,036)
DEFICIT, BEGINNING OF YEAR	**(34,216,936)**	(29,351,900)
DEFICIT, END OF YEAR	**(34,814,584)**	(34,216,936)
LOSS PER SHARE (Note 13)		
Basic and diluted	**(0.02)**	(0.15)

CONSOLIDATED BALANCE SHEETS
JUNE 30, 2004 and 2003

	2004 $	2003 $
ASSETS		
CURRENT		
Cash and cash equivalents	**1,849,221**	2,784,316
Accounts receivable		
Trade	**243,554**	272,020
Other (Note 6)	**187,254**	372,863
Inventory	**142,813**	16,328
Prepaid expenses and deposits	**352,865**	471,219
	2,775,707	3,916,746
Other receivables (Note 6)	**49,470**	79,160
Capital assets (Note 8)	**1,766,256**	1,451,258
Deferred development costs (Note 9)	**118,430**	-
Patents and trademarks	**75,045**	81,225
Goodwill (Note 5)	**1,666,679**	1,666,679
	6,451,587	7,195,068
LIABILITIES		
CURRENT		
Accounts payable and accrued liabilities	**695,220**	823,133
Income taxes payable	-	7,133
Current portion of long-term debt (Note 10)	-	37,200
Current portion of obligations under capital leases (Note 11)	**9,726**	21,678
Deferred revenue	**412,736**	550,093
	1,117,682	1,439,237
Long-term debt (Note 10)	-	35,035
Obligations under capital leases (Note 11)	-	7,503
	1,117,682	1,481,775
NON-CONTROLLING INTEREST	-	1,428
CONTINGENCIES (Note 17) and COMMITMENTS (Note 15)		
SHAREHOLDERS' EQUITY		
Share capital (Note 12)	**33,123,324**	32,903,636
Contributed surplus	**7,025,165**	7,025,165
Deficit	**(34,814,584)**	(34,216,936)
	5,333,905	5,711,865
On Behalf of the Board	**6,451,587**	7,195,068

Paul Mercia
Director

James Milliken
Director

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30, 2004 and 2003

	2004 $	2003 $
CASH FLOWS RELATED TO THE FOLLOWING ACTIVITIES:		
OPERATING		
Net loss	**(597,648)**	(4,865,036)
Adjustments for:		
Depreciation and amortization	**505,067**	662,946
Loss on sale of capital assets	**-**	429,122
Loss on sale of foreign subsidiaries	**(1,428)**	-
Share of non-controlling interest in subsidiaries' activities	**-**	(39,994)
	(94,009)	(3,812,962)
Changes in non-cash working capital accounts		
Accounts receivable	**214,075**	385,791
Inventory	**(126,485)**	16,019
Prepaid expenses and deposits	**118,354**	1,472,156
Accounts payable and accrued liabilities	**(127,913)**	(48,545)
Income taxes payable	**(7,133)**	6,802
Deferred revenue	**(137,357)**	31,350
	(160,468)	(1,949,389)
FINANCING		
Capital lease payments	**(19,455)**	(77,047)
Other receivables (non-current)	**29,690**	-
Proceeds from issuance of share capital	**219,688**	-
Repayment of long-term debt	**(72,235)**	(458,100)
	157,688	(535,147)
INVESTING		
Acquisition of Comnet Corporation	**-**	(1,180,568)
Purchase of capital assets	**(806,571)**	(216,575)
Proceeds on sale of capital assets	**-**	22,323
Development costs incurred	**(123,579)**	(35,473)
Purchase of other assets	**(2,165)**	(6,678)
	(932,315)	(1,416,971)
NET DECREASE IN CASH AND CASH EQUIVALENTS	**(935,095)**	(3,901,507)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	**2,784,316**	6,685,823
CASH AND CASH EQUIVALENTS, END OF YEAR	**1,849,221**	2,784,316
Cash and cash equivalents are comprised of:		
Cash	**272,232**	344,859
Short-term deposits	**1,576,989**	2,439,457
	1,849,221	2,784,316
SUPPLEMENTARY INFORMATION		
Cash interest paid	**5,688**	1,038
Cash interest received	**58,203**	112,844

1. GOING CONCERN

These consolidated financial statements have been prepared on the assumption that the Company is a going concern and will continue its operations for the foreseeable future and will be able to realize its assets and discharge its liabilities in the normal course of operations.

The Company has incurred significant losses, has an accumulated deficit of $34,814,584 as at June 30, 2004 and incurred a loss of $597,648 for the year ended June 30, 2004. Over the past four years, the Company has continued to use the cash generated from a prospectus completed in fiscal 2000 to fund its operations. The Company incurred legal expenses of $452,638 in addition to the legal settlement expense of $222,689 and excluding the legal recovery of $107,985 during the year ended June 30, 2004. Management believes that these legal costs will not continue at similar levels in fiscal 2005.

The Company's viability is dependent upon increasing revenues, achieving and maintaining profitable operations, and maintaining positive cash flows.

The Company has taken action to address its future viability. In the fourth quarter of fiscal year 2004, the Company restructured its wholesale agreement with Sprint Canada, a subsidiary of Call-Net Enterprises Inc ("Call-Net"). Under the restructured agreement, the Company purchased the equipment that supports the network services Sprint Canada supplies to the Company's dial-up Internet services and will lease the associated PRI's, bandwidth, and co-location facilities from Call-Net. The Company paid $525,000 for this equipment and has saved $107,410 in the fourth quarter in communication costs. Additionally, the Company purchased Surf The Net Internet Services Inc. on September 9, 2004 (see Note 19) and continues to pursue further acquisitions.

If the going concern assumption is not appropriate for these consolidated financial statements, then certain adjustments would be necessary to reclassify long-term liabilities as currently due, certain liabilities and commitments would come due immediately (see Note 15), and the Company may not be able to realize its capital assets, deferred development costs, patents and trademarks, and goodwill.

2. NATURE OF BUSINESS

Cybersurf Corp. (the "Company") creates advanced technology software solutions for Internet service, Internet portal and new media applications, and provides dial up and high speed Internet access and long distance telephone services.

3. CHANGE IN ACCOUNTING POLICIES

Stock-based compensation

On July 1, 2003, the Company elected to prospectively adopt the fair value based method of accounting for options granted subsequent to July 1, 2003 under its stock-based compensation plan as recommended by the Canadian Institute of Chartered Accountants ("CICA"). No compensation expense has been recognized in the consolidated statement of loss for the year ended June 30, 2004 using the fair value based method as described in Note 12, as no options were granted in 2004. Previously, the Company accounted for its stock-based compensation plan using the intrinsic value based method and accordingly, did not recognize compensation expense in the consolidated financial statements for share options granted to employees and directors when issued at market value.

The Company's stock-based compensation plan and the impact on net loss and loss per share had compensation expense been recognized for options granted prior to 2004, using the fair value based method of accounting for stock options issued to employees is described in Note 12.

Impairment of long-lived assets

On July 1, 2003, the Company adopted new accounting standards for impairment of long-lived assets, which establishes the standards for recognition, measurement and disclosure of the impairment of long-lived assets. The standards require that long-lived assets be tested for recoverability whenever events or circumstances indicate that carrying value may not be recoverable. No impairment loss has been recognized in the consolidated statement of loss for the year ended June 30, 2004.

4. SIGNIFICANT ACCOUNTING POLICIES

Management is responsible for the preparation of the consolidated financial statements. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles using appropriate accounting policies, methods and estimates as selected by management giving consideration to the Company's circumstances.

Basis of presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Cybersurf Technologies Corp., 3web Corp., Comnet Corporation and Cyberus Online Inc. In 2003, the Company owned 50% of the outstanding shares of Cybersurf LA Holdings Ltd., and 51% of the outstanding shares of Cybersurf US Holdings Ltd. and Cybersurf Euro Holdings Ltd. ("Foreign Subsidiaries"). The results of these companies were consolidated with recognition of a non-controlling interest. In 2004, the Company sold their investment in the Foreign Subsidiaries for $Nil.

4. SIGNIFICANT ACCOUNTING POLICIES (Continued)

For the year ended June 30, 2003 and until the investments were sold, the Foreign Subsidiaries were accounted for using the equity method.

Revenue recognition

Subscription revenue is recognized in the month that the services are provided. Prepaid subscription revenue is deferred and recognized in the period that Internet service is provided to the subscriber.

Advertising revenue is recognized when the advertiser has been provided access to the Company's subscriber base.

Cash and cash equivalents

Cash and cash equivalents include cash on hand, balances with banks and highly liquid short-term deposits with a term to maturity of a year or less when purchased.

Inventory

Inventory of modems and operating supplies is carried at the lower of cost, determined on an average basis, and net realizable value.

Capital assets

Capital assets are recorded at cost and are depreciated using the declining-balance method at the following rates:

Signage	**15%**
Furniture and equipment	**20%**
Computer hardware under capital lease	**20%**
Computer hardware	**30%**
Computer software	**50% to 100%**

Telecommunications hardware is depreciated on a straight-line basis over the 3 years.

Leasehold improvements are depreciated on a straight-line basis over the term of the lease.

Deferred development costs

Research and development costs directly related to the Company's ability to deliver high-speed Internet service through cable in Western Canada have been capitalized. Upon the successful launch of these services, amortization of these costs will occur over a period of 2 years, on a straight-line basis.

Management reviews the unamortized balance annually to ensure that the deferred development costs are not impaired.

Patents and trademarks

Patents and trademarks are recorded at cost. Patents and trademarks are amortized on a straight-line basis over 5 years.

Goodwill

Goodwill, arising from the purchase of Comnet Corporation, is recorded at cost and is not amortized. The recorded amount of goodwill is tested for impairment at year end annually through an analysis of discounted cash flows to ensure that the fair value remains greater than, or equal to, book value. Any impairment will be charged to income in the period in which it is determined.

Stock-based compensation plan

The Company has a stock-based compensation plan which is described in Note 12. In accordance with the new accounting recommendation adopted July 1, 2003, compensation expense is recognized for the plan when the stock options are issued and amortized over the option's vesting period.

Income taxes

The Company uses the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are recorded based on temporary differences, which are the differences between the carrying amount of an asset and liability on the consolidated balance sheet and its tax basis. The Company records a valuation allowance for future income tax assets that are not more likely than not to be realized.

4. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Use of estimates

The amounts recorded for deferred development costs, deferred revenue, depreciation of capital assets and goodwill are based upon management's estimates. By their nature, these estimates are subject to uncertainty and the effect on the consolidated financial statements of changes in these estimates in future periods could be significant.

5. ACQUISITION

On May 29, 2003, the Company acquired all of the outstanding shares of an Internet service provider, Comnet Corporation ("Comnet") and its subsidiary Cyberus Online Inc., for cash consideration of $1,267,050.

This transaction has been accounted for using the purchase method with the results of operations being included in these consolidated financial statements from May 29, 2003.

The fair value of assets and liabilities acquired is as follows:

	$
Non-cash current assets	95,539
Current liabilities	(1,103,629)
Capital assets	568,783
Long-term liabilities	(46,804)
Goodwill	1,666,679
	1,180,568
Cash acquired	86,482
Net assets acquired	1,267,050

6. OTHER RECEIVABLES

	2004	2003
	$	$
Miscellaneous	**92,600**	292,600
Employee advances	**144,124**	159,423
	236,724	452,023
Less current portion	**167,466**	372,863
	69,258	79,160

Employee advances of $46,400 bear interest at 4.25%, are unsecured and due on demand. The balance of $97,724, receivable from an officer and director of the Company, is non-interest bearing until maturity, payable in monthly instalments of $1,649 due December 2007. Additional payments of $28,466 are scheduled to be made during fiscal year 2005. If not paid in full by the maturity date, the $97,724 advance will bear interest at 4.25%.

7. PROMISSORY NOTES RECEIVABLE

On February 24, 1998, the Company sold the Calgary software license for 3web advertising revenue to Nuburn Capital Corporation ("Nuburn") for proceeds of $4 million. The license provides Nuburn with the right to certain revenues derived in Calgary from 3web. Nuburn paid cash consideration of $1 million, which was recognized as revenue upon execution of the agreement and signed an acquisition promissory note for the remaining balance of $3 million. No portion of the initial cash receipt of $1 million from Nuburn has been deferred because in the opinion of management, it is probable the Company's share of estimated future advertising revenue will exceed the costs with respect to future marketing and development. The promissory note bears interest at 5% per annum, interest payable on March 31st of each year, which commenced in 1999. In July of 1999, the Company acquired an option to repurchase the license for $6,200,000.

For accounting purposes, the promissory notes receivable and the corresponding deferred revenue have not been reflected on the consolidated balance sheet to more appropriately reflect the contingent nature of the revenue source for the repayment of the notes. The contingent nature of the revenue source is due primarily to the reduced demand for Internet advertising. Revenue from the sale of the license will be recognized in the same period when collectability on the notes receivable is reasonably assured. For the year ended June 30, 2004 $Nil (2003 - $Nil) was recognized as revenue.

In addition, the Company entered into a separate long-term, incentive-based management agreement, for a term of 15 years (ending 2013), with Nuburn. The Company is to receive a 30% share of Nuburn's 3web revenue as payment towards the promissory note. The promissory note balance is to be paid in full by February 24, 2013. In the event that a balance remains of the promissory note after this date, the Company will forfeit any balance outstanding and the Company is also to receive 35% of such revenue to cover marketing and development costs.

The revenue to date by Nuburn on the Calgary license has been less than anticipated and is insufficient to cover the interest on the promissory note. During the year, the Company had received $Nil (2003 - $Nil) towards interest. The Company records interest income on the promissory notes only when collection is reasonably assured.

7. PROMISSORY NOTES RECEIVABLE (Continued)

The Company entered into an agreement on December 15, 1998 to sell the Edmonton software license for 3web to Growth Technologies '98 Limited Partnership ("Growth Tech"), for proceeds of $4,180,000. Growth Tech paid cash consideration of $1,969,000 which was recognized as revenue upon execution of the agreement and signed an acquisition promissory note for the remaining balance of $2,211,000.

On April 27, 2001, the Company entered into a settlement agreement with respect to litigation with Growth Tech. This agreement effectively cancelled the long-term note receivable due from Growth Tech on the sale of the Edmonton license.

The settlement agreement also provided for the recovery of an amount of $292,600 in Goods and Services Tax by the Company attributable from the Edmonton licensee. Of this amount, $200,000 has been collected and $92,600 is included in the Company's accounts receivable as at June 30, 2004.

In addition, effective March 1, 2001, the Company entered into a marketing agreement with Growth Tech to market, develop and distribute 3web in the Edmonton market. As compensation for these services, the Company receives 10% of adjusted gross sales from 3web advertising revenue and a further 40% of 3web Gateway advertising revenue as a management fee, 30% of adjusted gross sales from 3web advertising revenue as a service fee and retains certain other revenue. This agreement carries a 15 year term. For the year ended June 30, 2004, $Nil (2003 - $Nil) was earned from this agreement.

8. Capital Assets

	2004		
	Cost $	Accumulated Depreciation $	**Net Book Value $**
Signage	9,369	4,737	**4,632**
Furniture and equipment	677,534	382,837	**294,697**
Computer hardware under capital lease	57,422	28,991	**28,431**
Computer hardware	3,212,033	2,502,637	**709,396**
Computer software	1,004,528	861,275	**143,253**
Telecommunications Hardware	585,285	38,161	**547,124**
Leasehold improvements	246,477	207,754	**38,723**
	5,792,648	4,026,392	**1,766,256**

	2003		
	Cost $	Accumulated Depreciation $	Net Book Value $
Signage	9,369	3,921	5,448
Furniture and equipment	642,470	309,271	333,199
Computer hardware under capital lease	65,007	18,390	46,617
Computer hardware	3,170,047	2,208,223	961,824
Computer software	868,873	860,993	7,880
Leasehold improvements	246,477	150,187	96,290
	5,002,243	3,550,985	1,451,258

In the current year, capital asset additions totalled $806,571 (2003 - $216,575).

9. Deferred Development Costs

	2004 $	2003 $
Balance, beginning of year	-	163,486
Additions	**123,579**	35,473
	123,579	198,959
Amortization	**5,149**	198,959
Balance, end of year	**118,430**	-

Additions to deferred development costs represent the capitalization of costs related to the Company providing high-speed cable Internet service in Western Canada. As of June 2004, the Company successfully launched this initiative and capitalized costs are being amortized over a 2 year period.

In the previous fiscal year, additions to deferred development costs represented the capitalization of software programming labour costs related to development of new technology applications.

10. LONG-TERM DEBT

	2004 $	2003 $
Small business equipment loans, bearing interest at bank prime plus 2.5%, repayable in monthly instalments of $3,100 plus interest, maturing on dates up to January 2008 and secured by charges on certain capital assets	-	72,235
Less current portion	-	37,200
	-	35,035

11. OBLIGATIONS UNDER CAPITAL LEASES

	2004 $	2003 $
Year ending June 30, 2005	**11,699**	26,779
2006	-	8,909
Total minimum lease payments	**11,699**	35,688
Less amount representing interest (ranging from 7% to 16%)	**(1,973)**	(6,507)
Balance of obligation	**9,726**	29,181
Less current portion	**9,726**	21,678
	-	7,503

12. SHARE CAPITAL

Authorized

Unlimited number of common shares

Unlimited number of preferred shares

	Number of Shares	Amount $
I. Common shares		
Issued and outstanding, June 30, 2002 and 2003	32,164,855	**32,903,636**
Employee stock options exercised	226,829	**35,938**
Private placement	700,000	**183,750**
Issued and outstanding June 30, 2004	33,091,684	**33,123,324**
Contributed surplus related to common share purchase warrants (Note 12(a))		**7,025,165**

a) On July 19, 1999, the Company entered into an agreement with the supplier of wholesale network services. Under the terms of the agreement, the Company received $12 million cash of which $7 million was paid by the Company for prepaid wholesale network services. In return, the supplier received 1,724,138 common shares for a total consideration of $5 million and 7 million common share purchase warrants for the remaining $7 million. Each common share purchase warrant entitled the holder to purchase one common share at a price of $5.00 until July 19, 2002 and such warrants expired unexercised.

12. SHARE CAPITAL (Continued)

b) The Company has a stock option plan for the purpose of assisting and encouraging directors, officers and employees of the Company to work towards and participate in the growth and development of the Company by providing incentive options to purchase the Company's common shares. At June 30, 2004, 630,930 (2003 - 1,663,401) options were outstanding at option prices ranging from $0.13 to $1.24. These options expire at various dates through to June 2007.

	2004		2003	
	Share Options	**Weighted Average Exercise Price $**	Share Options	Weighted Average Exercise Price $
Outstanding,				
beginning of year	**1,663,401**	**0.54**	2,272,276	0.54
Exercised	**(226,829)**	**0.16**	-	-
Cancelled	**(805,642)**	**(1.15)**	(608,875)	(0.54)
Outstanding, end of year	**630,930**	**0.43**	1,663,401	0.54

The following table summarizes information about stock options outstanding at June 30, 2004

Exercise Price	Number of Options	Weighted Average Contractual Life (years)	Number of Options Exercisable
$0.13	69,766	1.84	69,766
$0.16	325,000	2.95	325,000
$0.26	85,652	1.84	85,652
$1.24	150,512	0.83	150,512
	630,930		630,930

In accordance with the Company's share option plan, these options have an exercise price equal to the market price at date of grant. No stock options were granted in 2004. The per share weighted average fair value of stock options granted during the year ended June 30, 2003 was insignificant using the Black-Scholes option pricing model and the following assumptions: risk free interest rate of 4.6%, expected life of 3.0 years and expected volatility of 84%.

Had the Company determined compensation costs based on the fair value at the date of grant for its stock options, net loss would have increased by an insignificant amount in 2003. The effect on compensation costs of using the fair value method omits the effect of awards granted before January 1, 2002.

13. LOSS PER SHARE

The loss per share figures are calculated using the weighted average number of common shares outstanding during the year and the diluted weighted average number of shares includes stock options as follows:

	2004	2003
	$	$
Basic	**32,207,227**	32,164,855
Diluted	**32,601,993**	32,277,172

Diluted loss per share is not disclosed as the effect on loss per share is anti-dilutive.

14. INCOME TAXES

The (recovery of) provision for income taxes differs from the result, which would be obtained by applying the combined federal and provincial income tax rates to the loss before income taxes. This difference results from the following items:

	2004	2003
	$	$
Loss before income taxes	**(600,982)**	(4,857,903)
Computed income tax recovery at statutory rate of 35.37% (2003 - 38%)	**(212,567)**	(1,846,003)
Decrease (increase) resulting from:		
Large corporation tax	**-**	7,133
Non-deductible expenses	**534**	3,020
Non-deductible amortization	**4,407**	58,839
Permanent differences relating to losses and deductibility of capital assets	**706**	163,045
Tax losses not recognized in the year that the benefit arose	**203,586**	1,622,353
Other	**-**	(1,254)
	(3,334)	7,133

14. INCOME TAXES (Continued)

As at June 30, 2004, the Company has non-capital losses of approximately $30,430,000 available to reduce future taxable income. These losses expire as follows:

	$
2005	117,000
2007	-
2008	7,090,000
2009	12,292,000
2010	4,282,000
2011	3,817,000
2012	2,832,000
	30,430,000

No recognition has been given in the consolidated financial statements to any potential tax benefits that may arise from utilization of these losses, and accordingly no future income tax asset has been recorded.

15. COMMITMENTS

Leases

The Company has entered into lease agreements for business premises and equipment operating leases with various terms until December 2007. Annual lease payments with respect to these leases are as follows:

	$
2005	353,800
2006	248,100
2007	122,200

Telecommunications

In addition, the Company has long-term contracts with telecommunications providers for data services and voice services based on pre-negotiated rates. The Company's primary commitment was renewed in July 2004 for an additional 5 years at the vendor's option from a pre-existing agreement. The Company's annual cost under the agreement, based on the current level of activity is approximately $2,304,000. Additional installation and cancellation charges apply as services are provided. If this contract was terminated, the Company would have to pay 50% of the remaining payments under the contract. As at June 30, 2004, if these contracts were terminated, the Company would have to pay approximately $5,760,000.

The Company also has numerous commitments with different wholesale broadband providers for access, interconnection, and local area network extensions over 2 and 3 years. The Company's cost under the agreement, based on the current level of activity is approximately $80,410 per month. As at June 30, 2004, if these contracts were terminated, the Company would have to pay approximately $1,338,000.

16. SEGMENT DISCLOSURE

The Company's reportable operating segments, as determined by management, are strategic operating units that offer different products and services. During the years ended June 30, 2004 and 2003, the Company operated two business units, Internet Access and Cybersurf Technologies ("CYT"). In May 2003, the Company acquired Comnet. Both 3web and Comnet provide Internet access in different markets and CYT develops and markets a broad range of software products and software related services.

	2004			
	CYT $	3web $	Intersegment Eliminations $	Total $
Revenue	502,877	10,652,893	(502,877)	10,652,893
Operating expenses	502,877	7,218,649	(502,877)	7,218,649
Depreciation and amortization	17,890	487,177	-	505,067
Segmented operating income (loss)	(17,890)	2,947,067	-	2,929,177
General and administrative, marketing and selling expenses				(3,466,542)
Interest on obligations under capital leases and long-term debt				(5,688)
Legal recovery				107,985
Legal settlement expense				(222,689)
Interest income				58,203
Loss on sale of foreign subsidiaries				(1,428)
Large Corporation Tax				3,334
Net loss				(597,648)
Identifiable assets (net of goodwill)	68,308	4,716,600	-	4,784,908
Capital expenditures	-	806,571	-	806,571

16. SEGMENT DISCLOSURE (Continued)

	2003			
	CYT $	Internet Access $	Intersegment Eliminations $	Total $
Revenue	651,678	7,016,756	(651,678)	7,016,756
Operating expenses	651,678	5,852,876	(651,678)	5,852,876
Depreciation and amortization	305,734	357,212	-	662,946
Segmented operating (loss) income	(305,734)	806,668	-	500,934
General and administrative, marketing and selling expenses				(5,069,459)
Interest on obligations under capital leases				(472)
Interest on long-term debt				(566)
Interest income				112,844
Loss on sale of capital assets				(429,122)
Share of non-controlling interest in subsidiaries' activities				27,938
Large Corporation Tax				(7,133)
Net loss				(4,865,036)
Identifiable assets (net of goodwill)	99,168	5,429,221	-	5,528,389
Capital expenditures	4,185	216,475	-	220,660

17. CONTINGENCIES

a) A statement of claim was filed against the Company by a former wholesale network services provider in April of 2002 for approximately $1.5 million. The Company has counter claimed for $2.0 million and the provider has filed its affidavit of documents. No further steps have been taken in the litigation. The outcome of this matter is indeterminable at this time.

b) The Company filed a statement of claim against Growth Technologies '98 Limited Partnership, the former holder of the 3web Edmonton license, and its General Partner, Softech Internet Management Corp., for the recovery of an amount of $292,600 in Goods and Services Tax plus interest and costs attributable to a settlement agreement that resolved outstanding issues relating to the Edmonton 3web license. The defendants to the Company's action have counter-claimed for damages of $10 million. The outcome of the counter-claim is indeterminable. The Company has been granted a summary judgement in its claim in the amount of $316,927 and costs on its claim and has to date realized and collected just over $200,000 on this judgement with the anticipation that it will shortly realize the balance of the judgement.

c) The Company was a defendant to three class action lawsuits or potential class action lawsuits in Ontario, B.C., and Quebec which allege the Company misled consumers relative to certain advertisements offering "Free Internet for Life". Canada Post Corporation is also named in these lawsuits. A settlement agreement involving a consumer refund offer and the requirement for the Company to provide three months of free Internet access has been entered into and implemented with Ontario and B.C. counsel resolving two of the three actions. The Ontario courts approved the certification of a national class excluding British Columbia but including Quebec. Based on the Ontario ruling, the defendants in the Quebec class action will be arguing this precludes the continuation of the Quebec lawsuit. The final outcome of the Quebec lawsuit is indeterminable at this time.

d) The Company has filed a statement of claim in Alberta naming a dissident shareholder, Mercury Partners & Company Inc. ("Mercury Partners"), its two principals, the General Partner of Softech Internet Management Corp. and others in relation to alleged improper actions regarding an attempt by the dissident shareholder to replace the Cybersurf board at the Company's last Annual General Meeting. The claim seeks compensation in excess of $6,000,000 and other relief. Discoveries are ongoing in this litigation. The dissident shareholder filed an appeal of an earlier Alberta court decision dismissing the dissident's claim against the Company in relation to the last AGM with costs to the Company but that appeal has now been finally struck for want of prosecution by Mercury Partners. To date, the Company has been awarded and collected $107,985 in legal costs in relation to Mercury Partners' unsuccessful court action and is awaiting collection of an additional $10,926. The outcome of the Company's lawsuit is indeterminable at this time.

No provision has been accrued for in the accounts for any potential loss on any of the aforementioned claims.

18. FINANCIAL INSTRUMENTS

Carrying values of cash and cash equivalents, accounts receivable and accounts payable approximate their fair values due to the short-term nature of these accounts. The carrying values of the obligations under capital leases and long-term debt approximate their fair value due to the cost of borrowing approximating the market rate for similar debt instruments. The carrying values of the employee advances are not materially different than their fair value.

The Company is exposed to credit risk to the extent that its customers may experience financial difficulty and would be unable to meet their obligations. However, the Company has a large number of diverse customers which minimizes concentrations of credit risk.

19. SUBSEQUENT EVENT

On September 9, 2004, the Company acquired all of the shares of Surf The Net Internet Services Inc. ("STN"). STN provides Internet services to the Toronto and central Ontario markets.

The Company paid, subject to certain holdbacks, $735,000 in cash to acquire STN's dial-up, residential high speed DSL and commercial high speed DSL subscribers.

The Company has not determined the allocation of the purchase price.